Respondent's Ex. G

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission On Its Own Motion,	)	
v.	)	
The Peoples Gas Light and Coke Company	)	01-0707
Reconciliation of revenues collected under fuel and gas adjustment charges with actual costs.	)	

REBUTTAL TESTIMONY
OF
THOMAS E. ZACK

Q. Please state your name and business address.

A. Thomas E. Zack, 150 North Michigan Avenue, Chicago, Illinois 60601.

Q. By whom are you employed?

A. The Peoples Gas Light and Coke Company ("Peoples Gas," the "Company" or "Respondent").

Q. What position do you hold with Peoples Gas?

A. I am Director of Gas Supply.

Q. What are your responsibilities in that position?

A. My present responsibilities include directing the activities of the Gas Supply Planning, Gas Supply Administration, Gas Control and Gas Storage Departments for both Respondent and North Shore Gas Company.

Q. Please summarize your educational background and experience.

A. In 1983, I received my Bachelor of Arts degree, with majors in Accounting and Business Administration, from St. Ambrose University in Davenport, Iowa. In 1986, I received a Masters of Business Administration, with a concentration in Finance, from DePaul University.

I began my employment with Peoples Gas in 1984 in the Auditing Department. In 1986, I transferred to the Financial Reporting Department. In 1988, I transferred to the Rate Research and Policy Department. Four years later I transferred to the Office of Corporate Planning. In November 1996, I transferred to the Rates Department as a Supervisor. In September 1997, I was promoted to Manager of the Rates Department. In October 2000, I was promoted to Director, Customer Relations. In March 2003, I transferred to the position of Director, Gas Supply.

Q. What are the issues in this proceeding?

A. The issues in this proceeding include the following:

- the prudence of Respondent's hedging strategy
- the prudence of the Gas Purchase and Agency Agreement ("GPAA")
- the prudence of certain off-system transactions
- use of Respondent's Manlove storage field and the rate treatment of hub services
- the appropriate accounting treatment for maintenance gas
- the adequacy of Respondent's internal controls for gas purchasing and management

- whether the intercompany services agreement needs to be amended
- the appropriateness of the storage optimization contract

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to refute, generally, allegations from the Illinois Commerce Commission Staff and intervenors that: (1) Respondent did not have an appropriate hedging strategy; (2) the process that led to and support for the GPAA were flawed; (3) rate treatment of federal jurisdictional interstate services -- what Respondent calls hub services -- is inappropriate and detrimental to customers; (4) Respondent's internal controls for gas purchasing and management are inadequate; and (5) the intercompany services agreement needs to be amended.

Other witnesses address these issues in more detail in their rebuttal testimony. Specifically, Mr. Frank Graves shows that Respondent's hedging policies were reasonable and appropriate under the business conditions and regulatory climate that existed at the time hedging decisions for the 2000-2001 winter were made. Messrs. Graves and David Wear show that the GPAA and costs incurred under it were prudent. Mr. Wear also demonstrates that an off-system transaction at issue (Transaction No. 19) was a reasonable operational decision, and Respondent's use of storage and related hub services are beneficial to customers. In addition, Mr. Wear addresses maintenance gas and the storage optimization contract. Mr. Thomas Puracchio addresses the capabilities and characteristics of Respondent's Manlove storage field in response to allegations about Respondent's use and maintenance of that field.

He shows that hub services have been beneficial to the field’s operations and have enhanced the reliability of service to gas charge customers. Ms. Grace describes how storage costs are reflected in the Gas Charge to pass through to customers the benefit of winter/summer price differentials and explains how refund amounts that Respondent is not contesting would be handled through the Gas Charge if the Illinois Commerce Commission (“Commission”) so orders.

Q. Please summarize your testimony.

A. First, my testimony will address policy matters that the Commission should consider in making its decision in this proceeding. Second, my testimony will describe how the magnitude of the proposed disallowances, in and of themselves, is unreasonable. Third, I will discuss some of the problems with the disallowance proposals related to the Gas Purchase and Agency Agreement. Fourth, I will address the inappropriateness of Staff’s position regarding the interstate hub transactions. Fifth, I will respond to Staff's audit recommendations and questions as to internal controls. Finally, I will respond to Staff’s assertion that the Company undertook certain transactions that were inappropriate as they were inconsistent with the intercompany services agreement.

Q. What are the policy matters that the Commission should consider in this proceeding?

A. First, the Commission, from a policy standpoint, should consider the need for consistency in regulation. There are two aspects of this principle -- consistency with the Commission’s treatment of the Company in prior cases and consistency vis-à-vis other utilities. Second, the Commission should carefully examine the departure of the proposed disallowances from the prudence standard. That is, the Commission should be closely guarding against proposals that are based solely on hindsight review and mere difference of opinion. Third, the Commission should consider the extremely punitive nature of the amounts of the proposed disallowances in this proceeding.

Q. Please elaborate on the principle of consistency.

A. Several Staff and intervenor recommendations are based on theories that are contrary to well-established Commission policies. As a regulated utility, Respondent necessarily relies on prior Commission orders and statements, such as notice of inquiry reports, to guide its decision making. It would be troubling if good faith reliance on those orders and statements did not afford substantial confidence that decisions consistent with those orders and statements would withstand after the fact regulatory scrutiny. As examples:

1. The Commission has consistently not required utilities to financially hedge gas supplies and has not imposed an obligation to mitigate price volatility through the use of financial hedging. Yet, some of the same parties who raised these issues in the past, and lost, are back again in this case and making the same recommendations.
2. The agreement the Company had executed with Enron was in effect in fiscal year 2000 and Respondent's fiscal year 2000 gas costs were found prudent by the Commission. Neither Staff nor intervenors raised any concerns about the agreement during the 2000 proceeding. However, Staff and intervenors in this case are taking positions that would be

inconsistent with the Commission's order in that proceeding. Moreover, Staff's recommendation is based on requiring the Company to have performed an analysis of a sort that the Commission has not required in the past.

3. Respondent's hub activities, which have been taking place since 1998 and involve hundreds of transactions, have never been found imprudent or inappropriate in past cases. However, now they are suddenly questioned by the Staff when gas prices spiked higher.

It is unreasonable to make utilities operate in an environment where previous decisions and stated positions cannot be relied upon for direction. It implies that "reasonable people" would pay no attention to previous Commission decisions. In the past, financial analysts have viewed Illinois as a reasonable regulatory climate, but acceptance of the proposals of the Staff and intervenors, which depart from findings already made by the Commission, would jeopardize that viewpoint.

Q. Please explain your point regarding the need for consistent treatment with other utilities.

A. With minor exceptions, the Commission has made the determination that other Illinois gas utilities were prudent in their gas purchases without subjecting them to the severe hindsight review being proposed by the intervenors in this docket. The Commission already issued orders for all Illinois utilities' 2000 reconciliation cases. Except for Respondent and North Shore Gas Company, those cases include the months October - December 2000, which was a period of relatively high gas costs. The Commission required only minor cost disallowances in two cases. No disallowance proposals related to financial hedging were made by Staff or intervenors or ordered by the Commission. A disallowance for Illinois Power (Docket 00-0714) was almost entirely overturned by the courts, with only a $3,000 disallowance remaining. The other disallowance was in the CILCO (Docket 00-0710) case where the Commission ordered a $49,120 disallowance for revenue received for management services for off-system transactions to be credited back to the gas charge. These two disallowances equated to less than 1/10 of 1% of the respective total gas costs. Neither of these disallowances were based on a decision not to use financial hedges, which is the theory underlying the entire adjustment proposed by Mr. Herbert and approximately one-half of the Citizens Utility Board's ("CUB") recommendation.

Likewise the Commission has already issued orders in 9 of the 14 gas charge reconciliation cases for 2001. There were no gas cost disallowances in those 9 cases. In the remaining cases (excluding Respondent and North Shore Gas Company), the Staff has recommended disallowances that are being contested, but none are for financial hedging. (I am also excluding Northern Illinois Gas Company from my discussion because it had a gas cost PBR in effect during the 2000 and 2001 years, and it was not subject to traditional prudence review.)

Q. Specifically with respect to hedging, what guidance had the Commission provided regarding the use of financial hedging going into Respondent's fiscal year 2001?

A. Mr. Graves addresses this at length in his rebuttal testimony. However, I note that in the Commission's Order for Respondent's fiscal year 1997 reconciliation proceeding (Docket 97-0024), which was issued on January 26, 2000, in rejecting Mr. Brian Ross' proposed adjustment, the Commission stated: "Clearly, the Commission has not created an obligation or responsibility to mitigate price volatility through the use of such financial tools and we decline to do so in his proceeding." According to the Order, Staff witness Zuraski stated in that same proceeding that, "[i]n his opinion hedging is not inherently better than speculating. … Furthermore, he posited that hedging is unnecessary in the case of consumers that tend to purchase natural gas through the PGA. … Finally, Staff urged the Commission not to order the Company to hedge more of its gas supply or to threaten a disallowance if hedging were not done to the extent discussed in Mr. Ross' testimony."

This was the last reconciliation case order issued for Respondent prior to the pending reconciliation period and prior to when financial hedges for 2001 would had to have been purchased. With this guidance by the Commission, it was clearly reasonable for the Company not to use financial hedging that was outside of its strategy and which it was not required to use.

Q. Please explain what you mean when you say that the Commission should carefully examine the departure of the proposed disallowances from the prudence standard.

A. Many of the witnesses quote the correct description of the prudence standard. However, they don't seem to want to apply the standard. As I will elaborate in connection with my testimony on the GPAA, those proposed adjustments are not based on the proper application of the prudence standard. For example, two witnesses propose a standard of "superiority," not reasonableness (see, for example, page 10 of Mr. Anderson's direct testimony and page 29 of Dr. Rearden's direct testimony). Also, given the fact that there were no proposed adjustments related to the GPAA in fiscal year 2000, but rather the adjustments were not proposed until after all of the negative publicity about Enron emerged, the proposed adjustments appear to be hindsight in nature. Finally, the prudence standard requires more than a mere difference of opinion. However, when one reviews the small magnitude of the proposed disallowances (approximately $9 million) in relation to the total gas costs under the GPAA in fiscal year 2001 (approximately $570 million), it appears that this does not even rise to a difference of opinion. Moreover, even when one looks at the supposed before-the-fact prudence review, the approximately $30 million calculated by Dr. Rearden (at the least, an overstatement as demonstrated by Messrs. Graves and Wear) compared to the potential total cost of the GPAA over the five-year term, over $2 billion, the matter still does not rise above the level of a mere difference of opinion.

Magnitude of Proposed Disallowances

Q. The City of Chicago witness, John Herbert, recommended a cost disallowance of approximately $230 million. Is a disallowance of that magnitude reasonable?

A. No, the proposed disallowance is unreasonable and punitive on its face. First, the proposal represents 26% of total gas costs for the reconciliation year. Second, the proposal is grossly disproportionate to Respondent's net income in the reconciliation year. It exceeds the Company's net income not only for fiscal year 2001, but for subsequent periods as well. Third, the comparison to expected fiscal year 2003 savings from financial hedging is inappropriate.

Q. Are these comments equally applicable to CUB's recommended disallowance?

A. Yes. CUB's two witnesses recommend nearly a $110 million disallowance. While only about one-half of the City's proposal, the recommendation is still clearly unreasonable and punitive.

Q. Why is the size of the recommended adjustment relative to total gas costs significant?

A. Mr. Herbert's and Mr. Ross's proposed adjustments both assume substantially lower winter period gas costs. Such a reduction would generally have driven Respondent's gas costs well below that of other Illinois utilities during the winter months. As I have previously pointed out, these utilities were not subjected to the extreme disallowances being proposed in this proceeding.

Q. You stated that Mr. Herbert's recommendation was an amount that is grossly disproportionate to Respondent's fiscal year 2001 net income. Why is this relevant?

A. I raise this point to respond to a misleading comparison in Mr. Herbert's testimony. Mr. Herbert, on page 56 of his direct testimony, claimed to provide context for his proposed disallowance by comparing it with Respondent's fiscal year 2001 revenues. That comparison is inappropriate because utility revenues include base rate revenues, gas charge revenues and utility taxes. If one were to make a comparison of this sort, a more apt comparison would be to net income. The Company's net income in 2001 was only $75 million. Both the proposed City disallowance and the CUB recommendations are far out of proportion to that figure. Basically, the City and CUB propose to wipe out the Company's entire profit for more than one year. The Company is only allowed, at most, dollar for dollar recovery of its gas costs. There is no opportunity to make a profit on the buying and selling of natural gas.

Q. You stated that Mr. Herbert's comparison to Respondent's estimated fiscal year 2003 savings from hedging was inappropriate. Why?

A. As a prefatory matter, I note that Mr. Herbert's testimony referred to Respondent's fiscal year 2002. In fact, the savings he quoted are Respondent's estimate for fiscal year 2003. In any event, his comparison does not provide any support for the recommendation in this proceeding. First, as discussed above and in Mr. Graves' rebuttal testimony, the comparison is not relevant because the regulatory climate in Illinois with respect to financial hedging was very different in fiscal year 2003 than fiscal year 2001. Second, there is nothing to support the conclusion that the two figures -- Mr. Herbert's recommended disallowance and the $140 million savings -- are comparable in any way.

Q. CUB witness Brian Ross, at page 14 of his direct testimony, claimed that Respondent has "no built in incentive, through exposure to price risk" to manage gas price volatility. Please comment on Mr. Ross' assertion.

A. Mr. Ross simply demonstrates that he misses the point. Guided by the Commission's statements and orders, the Company understood its task going into fiscal year 2001 to be minimizing gas costs, not volatility, while providing safe and reliable service. The Company has significant incentives to manage its gas costs. The Company's operating expenses increase with increased gas costs. Examples of such cost increases due to increased gas costs are increased borrowing costs to purchase the gas, increased customer service activities and increased uncollectibles (bad debt). The most significant of these is bad debt. Unlike the gas costs themselves, these expenses do not have an ongoing recovery process to be recouped. Rather, a representative amount of these expenses are determined in a rate case and recovered through base rates based on assumptions made at the time of the rate case. In the case of the Company, these rates were established in its last rate case in 1995.

In fiscal year 2001, actual gas costs totaled $884 million. Due to the lag in writing off receivables, the carry over effect of this high priced year led to bad debt write-offs in fiscal year 2002 of $54 million and about $43 million in fiscal year 2003. Given that the Company's net income in fiscal years 2002 and 2003 were only $78 million and $80 million respectively, these cost increases due to bad debt are extremely detrimental to the Company.

It is clear that the Company has an incentive to keep gas costs low, consistent with its obligation to provide safe and reliable service.

Q. Was gas price volatility a consideration for the Company for fiscal year 2001?

A. While the Company's focus is on minimization of gas costs, it does not ignore volatility. The Company owns and leases significant amounts of storage to mitigate the need for purchases in winter periods and to take advantage of normally favorable summer/winter price differentials. The Commission has consistently found our storage practices to be prudent. The Company continued to hedge winter prices through its use of storage. About half of normal winter retail sales requirements are provided via storage. Had the Company not utilized storage to hedge, winter gas charges would have been significantly higher. Accordingly, the Company's storage was an effective hedge in fiscal year 2001, as demonstrated by Mr. Wear, who calculated a benefit to customers from storage of approximately $130 million.

Given the Commission's lack of encouragement for utility financial hedging, early financial hedging activities were very measured. Since initial hedging practices started, strategies for hedging have been evolving.

The Company's Price Protection Strategy dated August 1998 was driven by target prices for locking in hedged volumes. (Both Mr. Ross and Mr. Herbert incorrectly describe the document and a successor strategy as prepared by a consultant. The price protection strategy was prepared by the Company.) With the significant increase in prices leading into the winter of 2000-2001, the targeted price levels were never hit.

Q. Is it clear that in order to gain some price stability, customers are willing to pay the cost of hedging?

A. No. It seems only clear that after the fact, if prices could have been lower by hedging, customers would have wanted the lower price. But throughout 2001, and since the late 1980s, the Company's commercial and industrial customers, as well as many residential customers (multi-unit dwellings), have had the opportunity to pursue fixed prices options with another supplier through the various transportation programs the Company offers. The vast majority of those with that choice, have chosen to remain under the Company's Gas Charge. More than 75% of commercial customers have elected to stay with the utility for their gas supply, though they all had the option to transport their own gas. The interest in switching to another supplier for that price stability has been minimal.

Gas Purchase and Agency Agreement

Q. Are the proposed hedging adjustments the only examples of proposed adjustments seeking inconsistent treatment?

A. No, the proposed adjustments related to the GPAA also seek an inconsistent treatment from the Commission. Moreover, these proposals suffer from an improper application of the Commission's prudence standard.

Q. What is the inconsistency?

A. As I previously testified, the GPAA was in effect in fiscal year 2000. No party proposed a disallowance related to that agreement, and the Commission approved the Company's reconciliation of gas costs and revenues for that fiscal year.

Q. You testified previously that the Gas Purchase Agency Agreement was in effect during fiscal year 2000. In the reconciliation case for that fiscal year, did the Commission Staff request the sort of study advocated by Dr. Rearden in this proceeding?

A. No. Moreover, in prior cases, Respondent has generally supported its portfolio of supply and capacity contracts in much the same manner as it has done in this case. In past reconciliation years, Staff has found the Company's purchase practices and support for those decisions to be prudent. It has never been asked to produce the type of study that Dr. Rearden included with his testimony. Moreover, for the reasons discussed by Mr. Graves, such a study is not a necessary part of evaluating the prudence of a gas supply agreement. Again, this creates the problem of inconsistency that the Commission should avoid.

Q. The Staff witnesses concluded in several instances that some aspect of the GPAA is not "superior" to Respondent's historical practices (see, for example, page 10 of Mr. Anderson's testimony and page 29 of Dr. Rearden's testimony). Is it your understanding that prudence requires a utility's performance each year to be superior to what it achieved in prior years?

A. Although prudence is a legal standard and Respondent will address this issue in its briefs, it is my understanding that prudence is basically a test of reasonableness and does not require decisions to produce results that are superior to the result that may have been produced by a different approach or superior to what Respondent achieved in prior years. My understanding is that prudence is based on what would have been reasonable based on information known at the time decisions were made. Respondent has shown that the GPAA, as well as Respondent's other gas costs, meet this standard and that following Respondent's prior practices would not have been a better approach to addressing the circumstances that existed when the Company was negotiating the GPAA. While Respondent strives to improve its processes and results and produce superior results, it is my understanding that this is not the basis for evaluating gas costs in a reconciliation proceeding. Again, from a consistency standard, I do not believe the Commission has previously demanded that Respondent or any other utility meet such a standard.

Q. Would you please comment on the magnitude of the Staff's and the Attorney General ("AG") witness David Effron's proposed disallowances for the GPAA in light of the prudence standard of reasonableness?

A. While Messrs. Wear and Graves will address their recommendations in detail, I do have a general comment about the proposals. As Staff points out, Respondent paid approximately $570 million in gas costs to ENA. Yet, Staff's proposed disallowance is a bit less than $9 million. Mr. Effron's proposed disallowance, which he attributes to the GPAA, is $8.1 million; in fact, much of his proposal is based on conjecture that an off-system transaction (Transaction No. 19) is somehow related to the GPAA. In other words, Staff's proposal represents only about 1.6% of the GPAA costs, and the AG's proposal is even less. If Transaction No. 19 were considered separately, as it should be, and not artificially tied to the GPAA, the AG's GPAA-related recommendation would have been $2.6 million, which is less than ½% of the payments to ENA in fiscal year 2001. These percentages would be even lower if one included gas costs for fiscal year 2000 and the zero disallowances determined in that reconciliation case. Specifically, for the two-year period, the recommended disallowances total about $9 million and total costs under the GPAA were about $900 million. Let me use an analogy to put this into context. If a consumer went to the grocery store and bought an item for $1.00 and a similar item was available at another store down the street for 99¢, using Staff and Mr. Effron's relative comparison, they would have called that purchase imprudent.

Moreover, both analyses address only contract features that the witnesses believed could be quantified. No consideration is factored in for other contract terms that provide other benefits. Such relatively small proposed adjustments in the context of a complex contract represent a difference of opinion about the costs and benefits of the contract and belie Staff's and the AG's strident conclusions that the GPAA is clearly imprudent. Moreover, Staff's "before-the-fact" review looked at only a single scenario that was possible at the time the GPAA was entered into -- clearly there was not a single scenario that every reasonable person agreed to at that time. Messrs. Wear and Graves discuss this in more detail in their testimony.

Q. Mr. Lounsberry, on pages 4-5 of his direct testimony, stated that Staff had inadequate time to review the GPAA in fiscal year 2000. Please comment.

A. That is clearly not supported by the record in that case. During that case (Docket 00-0720), Staff did not ask the Administrative Law Judge for additional time. While the Commission and the Administrative Law Judge directed that the cases be handled expeditiously, that did not preclude the Staff from requesting additional time if it believed the time was needed to complete its review. Although I cannot know the extent of Staff's review, I question the conclusion that the review was hampered by lack of time. Consider:

- Approximately one month after the GPAA was signed in the fall of 1999, Staff requested and Respondent provided a copy of the GPAA to Staff. One must assume that they requested it in order to review it. Moreover, Staff had the authority to request additional information about the GPAA outside the context of a reconciliation proceeding. If its review of the GPAA indicated a need for such additional information, it was free to request it at any time.
- Staff's testimony was submitted in late May of 2001. That means that Staff had in excess of 1 ½ years to review the contract before filing testimony.
- Staff submitted data requests, to which the Company responded, about the GPAA during the fiscal year 2000 gas charge reconciliation case. The

Staff's direct testimony in the 2000 reconciliation case asserted that it was based on, among other things, responses to extensive data requests.

- There was no cut-off date for discovery in the 2000 reconciliation case.
- There was no set deadline for completing the 2000 reconciliation case.
- The Company, in response to comparable data requests, provided Staff the same information on the GPAA in the 2000 reconciliation case as they have in this case. Nothing in Staff's testimony suggests a lack of careful consideration.

One cannot, for purposes of the integrity of this process, conclude that a contract was prudently entered into in one year and then, the following year, conclude that the it was imprudent to enter into the same contract. That would be an unreasonable precedent for the Commission to establish. Moreover, it would stand the Commission's prudence standard on its head when dealing with a multi-year contract such as the GPAA. For example, the GPAA was in effect for fiscal year 2002. For purposes of the proceeding for fiscal year 2002, was it prudent to have entered into the GPAA in 1999, as determined by the Commission in the fiscal year 2000 reconciliation proceeding, or was it imprudent to have entered into the GPAA in 1999, as argued by the Staff and Mr. Effron in this proceeding?

Q. Was there anything in Staff's testimony or the Commission order that suggested the review of fiscal year 2000 gas costs was anything less than thorough?

A. No. For example, page 2 of the Commission's Order stated: "Staff witness Steven Cianfarini, a Senior Energy Engineer in the Engineering Department of the Energy Division, testified as to the Commission's definition of 'prudence.' He then stated that, after reviewing the Company's testimony and responses to extensive data requests, he did not find that the respondent made any imprudent purchases."

Page 5 of that same order, in the Commission Analysis and Conclusions section, stated: "All parties were afforded the opportunity to conduct discovery, cross-examine all witnesses, and present any evidence with respect to any issue in this proceeding. … Respondent presented detailed evidence in support of the prudence of the gas costs that it recovered through its PGA during the reconciliation period. In evaluating this evidence, Staff used the appropriate standards adopted by the Commission to review prudence, and found no evidence of imprudence."

Finally, page 10 of the order, in the fourth ordering paragraph stated: "during the reconciliation period there was no evidence to indicate that Respondent had not acted reasonably and prudently in its purchases of natural gas."

These references are important in that the GPAA had been in place during the 2000 reconciliation case and the same test of prudence was used in that case.

Q. Were Respondent's costs under the GPAA so insignificant in fiscal 2000 as to not require a total review during the reconciliation proceeding?

A. No. Respondent incurred about $336 million in gas costs in fiscal year 2000 under the GPAA. These costs represented about 74% (more than the 64% in 2001) of Respondent's total gas costs in fiscal 2000. As Mr. Wear discussed in his additional direct testimony (page 28), the terms of the GPAA in fiscal year 2000 were substantially identical to the terms in effect in fiscal year 2001. Neither Staff nor any party recommended any disallowances in fiscal year 2000 related to those or any other costs, and the Commission found that Respondent's gas costs were prudently incurred.

Interstate Hub Transactions

Q. Dr. Rearden stated, on page 49 of his direct testimony, that "[r]atepayers must wait for a future rate case and hope that the firm premiums for non-tariff services make their way into the Company's above-the-line test-year revenues." Is there anything unusual about this approach?

A. No. Dr. Rearden is simply pointing out the Commission's long-standing practice. The Commission establishes base rates reflecting, very generally, costs and revenues for a test year. Specific elements of costs go up and down, as do revenues, but the Commission does not adjust rates based on a single item. Rather, it waits until a rate proceeding and then examines all costs and revenues. There are limited exceptions to this general principle. For example, the Commission has authorized certain costs and revenues to be accounted for in riders. Gas costs and revenues are an example. Hub revenues, however, are properly considered a base rate item.

Dr. Rearden's statement that customers have to "hope" that the rate case process will properly handle above-the-line revenues, such as hub revenues, makes the process sound like a lottery. The rate case process is one with which the Commission and its Staff have considerable experience and expertise. There is nothing unique about hub costs and revenues that would create uncertainty about the proper treatment of these costs and revenues in a rate case. Hub revenues are above-the-line utility revenue and would be treated accordingly.

Between rate cases, the Company cannot recoup increased costs that are recoverable through base rates, nor is it obligated to relinquish increased revenues that it may realize through more efficient use of assets. For example, the Company cannot increase the cost recovery for bad debt between rate cases, even though it has increased significantly since the last rate case. Both base rate costs and revenues would be addressed and reviewed in the Company's next rate case.

The Company provides quarterly reports to the Commission that provide financial performance results including the Company's rate of return. These returns include the benefits of hub revenue. If the Commission determined that the Company's returns were out of line, they could cite the Company in for a rate case. They do not have to wait for the utility to file a rate case. Because the Commission has not cited the Company in for a rate case, it is reasonable to conclude that the Commission does not believe that the Company's earnings have not been out of line.

Q. Do you know if any other Illinois utility has had hub costs and revenues addressed in a rate case?

A. Yes. Nicor Gas' last rate case addressed its "Chicago hub revenues." The Commission, noting its decision in a prior Nicor Gas case related to the accounting treatment of hub revenues, made an adjustment to reflect the treatment of hub revenues as above-the-line. Neither the rate case nor the preceding case concerning accounting treatment provided for flowing revenues through the gas charge. Had Respondent been operating its Hub at the time of its last rate case, it would presumably have received similar treatment.

Q. Mr. Lounsberry, on page 5 of his direct testimony, stated that these transactions "had not come to Staff's attention prior to its review in the instant proceeding." Please comment.

A. I am surprised that Staff takes that position. First, as I mentioned, the precedent for hub transaction revenues was set in Nicor Gas' last rate case as well as a Nicor Gas proceeding regarding accounting treatment of hub revenues. Second, the Commission was a party to Respondent's filing at the Federal Energy Regulatory Commission ("FERC") in which it sought, and received, permission to implement an Operating Statement to offer certain hub transactions. Respondent made this filing in November 1997 and the FERC issued orders in March 1998. Third, FERC rules require Respondent to file an annual transportation report and a semi-annual storage report. The FERC rules require that the certificate holder serve the transportation report on its state commission. Respondent serves both the transportation and the storage reports on the Commission. Finally, the Commission also intervened in Nicor Gas' certificate application at the FERC and at least two Nicor Gas FERC rate proceedings related to its hub. There is ample reason to believe that the Commission and its Staff are aware of FERC-jurisdictional transactions performed by Illinois utilities, including Respondent's activity. As stated earlier, the hub has been in existence since 1998, and Staff has never voiced the concerns it raises in this proceeding.

Audit Recommendations and Internal Controls

Q. Mr. Knepler proposed that the Commission impose certain internal and external auditing obligations on Respondent. Are these recommendations needed?

A. No. First, Respondent believes that Staff is using a single mishandled off-system transaction -- identified as Transaction No. 16/22 -- to bootstrap itself to the conclusion that there are major flaws in Respondent's processes. Contrary to Dr. Rearden's testimony (page 41 of his direct testimony), Transaction No. 16/22 is not, nor was it ever, representative of Respondent's practices. Second, Staff's citation to hub transactions as a reason for an audit is misplaced. While Staff claims not to have been aware of FERC jurisdictional transactions prior to this proceeding and while Staff objects to those transactions, that has nothing to do with internal controls and procedures. Third, Staff's objections to transactions involving affiliated companies and various Enron entities -- but not Respondent -- provide no support for an audit. Fourth, an audit should consider circumstances as they exist at the time of the audit and make forward looking recommendations.

Respondent has made improvements to its processes that obviate the need for an audit based on Staff's conclusion that Respondent's practices were deficient.

The Company believes that a Commission imposed management audit is unnecessary at this time. While the Company is always concerned with gas supply documentation, analysis and internal controls, we believe that steps are already underway to improve in these areas.

Q. Why is Transaction No. 16/22 not the basis for an audit?

A. The transaction and errors associated with the transaction were unique in fiscal year 2001. No system can completely prevent errors or mishandled transactions. Respondent makes hundreds of gas supply decisions every year. Looking only to off-system transactions, there were 103 such transactions in fiscal year 2001. Yet, Staff is focusing on this single transaction to paint a picture of poor processes. Additionally, as described below, there have been improvements in processes to avoid similar problems.

Q. Why are Staff's concerns about hub transactions not the basis for an audit?

A. As stated above, Staff's concerns about the hub relate more to the fact that it ignored the hub prior to this year and its incorrect belief that the hub transactions adversely affect gas costs. Those concerns have nothing to do with processes that would be the subject of an audit. It is inconsistent treatment of the Company from prior cases.

Q. Why are concerns about affiliates and Enron not the basis for an audit?

A. Beginning with its bankruptcy filing in December 2001, no Enron wholesale gas entity conducted any significant amount of business, other than winding up some transactions. Respondent has conducted no business with ENA or any of its affiliates since the court-approved termination of the GPAA in March 2002. enovate no longer exists. Neither Respondent nor any of its affiliates entered into a comparable venture subsequent to the dissolution of enovate. Given the forward looking nature of an audit, the perceived concerns about Enron are irrelevant.

Q. Please describe changes that Respondent has made subsequent to the reconciliation year.

A. Since fiscal year 2001, the Company has taken, or is in the process of taking, steps to improve its internal controls.

<u>Policies and Procedures</u>

- Restrictions have been tightened as to which personnel are authorized to make gas supply deals.
- In late 2001, the Company began investigating a voice recording system for use in the daily gas supply purchasing activity. In June, 2002 the Gas Supply area began using such a system. These recordings are also used on an as needed basis if differences of opinion are being discussed with suppliers or pipelines.
- Currently, documentation gaps are being identified and Gas Supply procedures are either being reviewed or developed. Processes that have

not yet been documented are scheduled to be completed within the next six months.

Staffing Changes

- In February, 2003 a new position was created in Gas Supply Administration to add emphasis on controls and analysis. The job consists of identifying gas supply needs, providing analysis to support the decision-making process, assisting in contract negotiations, and ensuring that contracts are executed in a timely manner. In addition, the job entails developing and maintaining policies and procedures for documenting and recording gas supply transactions and ensuring that all executed deals conform to these guidelines as well as to the terms and conditions of the contract.
- The Gas Supply area has recently filled two positions with personnel having accounting backgrounds. The Company believes this will help strengthen the documentation and internal controls in the area.

New Software - Monaco System

- The Company is in the process of installing new software that will improve the tracking and documenting of gas supply activity and transactions. The software called "Monaco" is provided by Woodlands Technology, LLC. The software is scheduled to be installed this year. The software provides for capturing comprehensive transaction information, contract administration, audit functionality and management reporting.

Sarbanes-Oxley

The Sarbanes-Oxley Act of 2002 requires companies to document and test the business processes used to create their financial statements. Beginning in 2004, when a company files its annual report, it must guarantee that its internal controls have been written down and tested by outside auditors. The Gas Supply Procurement process is included in this review. The Company has assembled a project team to assure that the Company meets these requirements.

Given the scope of the Sarbanes-Oxley project, the Company believes that a second audit by the Commission may unnecessarily duplicate and add costs to the work being done for Sarbanes-Oxley compliance. Therefore, the Company proposes to submit to Staff a report that addresses Staff's concerns one year from the date of an order in this proceeding; that time frame allows for the above activities to be completed.

Intercompany Services Agreement

Q. Mr. Knepler testified that certain transactions were inappropriate because the Commission did not approve them. For example, he mentioned a transaction with enovate (page 30 of Mr. Knepler's testimony). Please comment.

A. Whether a particular transaction requires Commission approval is a legal issue, and Respondent will refute these allegations in its briefs. However, I note that it is unclear to what transactions Mr. Knepler is referring. For example, if he is talking about enovate's purchase of FERC Operating Statement services from Respondent, I am advised by counsel that such transactions do not require Commission approval and are not conducted pursuant to the intercompany services agreement.

Q. Mr. Knepler cited, on page 33 of his direct testimony, a particular supplemental agreement associated with the intercompany services agreement and stated that the Commission had not approved it. Please comment.

A. Again, this is a legal issue, and Respondent will refute these allegations in its briefs.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.